City of Detroit
CITY COUNCIL

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TO: The Honorable City Council

FROM: David Whitaker, Director
Legislative Policy Division Staff

DATE: September 15, 2014

RE: Supplemental Report on the $275,000,000 Exit Financing Recovery Bonds

The Legislative Policy Division (LPD) has received responses from Miller Canfield regarding our outstanding questions on the $275,000,000 Exit Financing financial recovery bond transaction. The questions were raised in our report entitled "$275,000,000 Exit Financing Financial Recovery Bonds" dated September 10, 2014 your Honorable Body received last Wednesday. LPD appreciates receiving these responses.

LPD below restates our outstanding questions and we have included the response from Miller Canfield.

1. Will the Barclays' commitment letter, term sheet, disclosure statement, etc. now have to be revised to reflect a transaction up to $325 million? Would newly executed documents be required?

Response from Miller Canfield:

The City and Barclays would need to sign a new commitment letter or amend the existing commitment letter to upsize the financing to $325 million, which Barclays has verbally agreed to do. We don't anticipate the term sheet would change, but for the amount. The disclosure statement would not change.

LPD's comment:

The response is unsatisfactory since a revised executed commitment letter and term sheet increasing the Exit Financing transaction amount from $275 million to $325 million the Emergency Manager is now seeking approval for from your Honorable Body is unavailable at this time from Barclays Capital, Inc. (Barclays), even though Barclays has given the City a verbal agreement to the increased financing amount.

LPD would also like to remind the Council that on August 14th your Honorable Body approved a bond authorization enabling the Emergency Manager to issue up to $55 million in limited tax general obligation financial recovery bonds for the purpose of financing the City's settlement of certain claims of the holders and insurer of certain City limited tax general obligation bonds as provided in the Plan of Adjustment. LPD understands from Miller Canfield that the increase in the Exit Financing bond transaction amount of $50 million could enable the Emergency Manager to instead use proceeds from the Exit Financing to settle the outstanding limited tax general obligation claims at potentially a lower cost the City due to a lower interest rate on the Exit Financing bonds.

LPD has requested that Miller Canfield or Miller Buckfire provide your Honorable Body what the overall savings could be if Exit Financing proceeds were used to settle the outstanding limited tax general obligation claims rather than using new limited tax general obligation financial recovery bond proceeds.

LPD recommends that Council postpone its vote on the Exit Financing bond transaction until you receive a revised executed commitment letter and term sheet from Barclays. The amended request from the Emergency Manager is dated September 9, 2014, which technically allows Council to vote on the Exit Financing by Friday, September 19th. Council could set a special session sometime on Friday, September 19th to give the Emergency Manager some extra time to receive a revised executed commitment letter and term sheet from Barclays with the Exit Financing transaction amount of $325 million.

2. Please explain why it may be more advantageous to use Exit Financing proceeds to address the LTGO settlement rather than using the proceeds from the new LTGO bonds Council approved on August 14th.

Response from Miller Canfield:

If taxable long-term financing is available to the City at a lower all-in-cost than 5.65%, the City may elect to retire the new LTGO bonds and reduce its debt service costs. In addition, the City would then have fewer debt instruments.

LPD's comment:

For more clarity, Miller Canfield has expressed that the Emergency Manager would not issue the new LTGO bonds if it was more inexpensive to the City to issue Exit Financing bonds to pay the outstanding LTGO settlement. Miller Canfield also indicated that the settlement agreement with the LTGOs allows the City to issue the New LTGOs <u>or</u> pay cash, which could be done through the exit financing.

3. How does a not to exceed $325 million transaction impact the amortization schedule of the not to exceed $275 million transaction?

Response from Miller Canfield:

The amortization of both transactions has yet to be determined. Both transactions would be fully amortized within 15 years.

LPD's comment:

For more clarity, LPD reported in our September 10th report that with a $275 million Exit Financing bond sale, the interest only payments could be $14 million annually for the first five years, then the principal and interest payments could be $36 million annually for the following ten years until year fifteen.

There could be a sizable increase in debt service (principal and interest) payments if the Exit Financing bond transaction increases from $275 million to $325 million. However, there could be an overall net savings to the City if the Emergency Manager elects not to issue $55 million in new LTGO bonds Council approved on August 14th, and instead issue the Exit Financing bonds at a lower interest rate, as discussed in the LPD comment section under question one above.

4. Response to question 3.b. (first set of questions): casino tax dollars were used to pay off swaps to get down to a balance of $45 million?

Response from Miller Canfield:

The swap obligation settlement is $85 million. Pursuant to the original Collateral Agreement with the swap holders, casino revenues are being used to pay the monthly interest obligation which reduces the amount due on the settlement agreement. In is anticipated that the settlement will have $45 million remaining at bankruptcy exit.

LPD's comment:

This response is acceptable.

5. Response to question 3.d. (first set of questions): the amounts listed add up to $300 million. Without using $55 million for potentially settling the LTGO claim, the amounts would add up to $245 million, which looks like even $275 million would be too much. When including the $55 million, there is about $25 million to spare, if Council were to authorize the revised resolution for not to exceed $325 million. Would the $25 million be added to the "new capital expenditures" category to provide up to $105 million for this category?

Note: LPD feels question 11 below restates question 5 more clearly. Please see response from Miller Canfield and LPD's comment for question 11 below.

6. Response to question 10 (first set of questions): please briefly explain why casino tax revenue is now "restricted in their use"?

Response from Miller Canfield:

State law has always restricted the use of casino tax revenues. See MCL 432.212

LPD's comment:

This response is acceptable. MCL 432.212 of the Gaming Control and Revenue Act states that "the wagering (casino) tax shall be used for a) hiring, training, and deployment of street patrol officers; b) neighborhood and downtown economic development programs designed to create local jobs; c) public safety programs such as emergency medical services, fire department programs, and street lighting; d) anti-gang and youth development programs; e) other programs that are designed to contribute to the improvement of the quality of life in the city; f) relief to the taxpayers of the city from 1 or more taxes or fees imposed by the city; g) the costs of capital improvements; and h) road repairs and improvements".

This is why Miller Canfield indicated in its first set of responses that the pledge of income tax revenues has become an accepted structure in the municipal market.

7. Response to question 11 (first set of questions): is the reason why financial recovery bonds are subject to the legal debt margin because these bonds are in substance revenue bonds and not general obligation bonds? Or, does State statute specifically says that financial recovery bonds are not subject to the legal debt margin?

Response from Miller Canfield:

Section 36a(7) of the Home Rule City Act specifically excludes bonds issued pursuant to that section from debt limits.

LPD's comment:

This response is acceptable. MCL 117.36a(7) of the Home Rule City Act in part states that "financial recovery bonds issued pursuant to this subsection are not subject to subsection (4)"[1].

8. The $412,500 Exit Financing transaction fee being paid to Barclays, which appropriation in Non-Departmental would that come from?

Response from Miller Canfield:

The City's general fund.

LPD's comment:

The response does not identify which appropriation in Non-Departmental the commitment fee to Barclays would come from. But this it is not critical to know the appropriation at this point. LPD will inform Council the appropriation upon the point it is communicated to us.

9. The City first issues the bonds to Michigan Finance Authority (MFA) who may sell the bonds to Barclays at close to par. Put in another way, the City will issue financial recovery bonds which would be sold to the MFA who will issue exit financing bonds which bonds would be sold to Barclays. This is a typical transaction flow with regards to Home Rule Section 36a(7) bonds, correct? Does selling the bonds through the MFA helps to achieve a lower interest rate as well? At any rate, there will only be one set of bonds outstanding, correct?

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[1] Subsection (4) of MCL 117.36a of the Home Rule City Act states "notwithstanding subsection (1), the net indebtedness of a city, reduced by any amounts excluded under section 4a(4), shall not exceed 20% of the assessed value of the city", a/k/a "legal debt margin".

Response from Miller Canfield:

The bonds are being issued under Section 36a(7) of the Home Rule City Act, which allows the City to sell bonds secured by the income tax revenues. As it exits bankruptcy the City is unable to borrow on an unsecured basis (in fact this is something the City has to demonstrate to the court). All of the firms which responded to the RFP required the bonds to be secured. While technically the City could issue bonds under Section 36a without selling them to the MFA (as is the case with the New LTGO Bonds and the New B Notes), the only way the City can borrow on a secured basis is by issuing refunding bonds through the MFA under Section 36a(7) (to which it may add new money). The structure described in your question is typical of the structure of any bonds sold through the MFA. The market regards the sale of the City's bonds through the MFA favorably because they regard the State's involvement as making repayment more likely. In addition use of the MFA in this case allows a statutory lien to be placed on income tax revenues set-aside for payment of the bonds. This allows the City to secure the bonds and obtain a lower interest rate as a result. Payments on the City's bonds are used to pay the MFA bonds, so from the City's perspective there is only one obligation outstanding.

LPD's comment:

This response is acceptable.

10. Amortization is five (5) years from closing date. Does this mean that the bonds can be called by the City in five years?

Response from Miller Canfield:

Amortization begins in five years. That just means that the City will begin to pay principal in five years. Optional redemption provisions will vary. Once the bonds are publicly offered, the taxable bonds would remain callable at any time and the tax exempt bonds would become callable in ten years.

LPD's comment:

This response is acceptable.

11. Looking at the Barclays proposal, LPD feels the use of the proceeds would be used in the following manner. If only $275 M in bonds are sold, $45 M would terminate remaining swaps; $120 M would be used to refinance QOL loan; $80 M would be used for RRIs; and the remaining $30 M would be used for costs of issuance and bond reserves. If $325 M in bonds is sold, the same as above but $55 M could be used for LTGO settlement and the remaining $25 M would be used for costs of issuance and bond reserves. Is this correct?

Response from Miller Canfield:

That is correct.

LPD's comment:

This response is acceptable.

12. What is the assumed interest rate at time of closing based on the variable rates?
13. Similarly, what is the assumed fixed interest rate at time of the public offering? By Barclays adding its balance sheet to this structure, does that help to secure a lower interest rate?

Response from Miller Canfield:

Indicative Rates from Miller Buckfire

Period One: Emergence to January 31, 2015 (estimated)

Tax-Exempt:
Principal: $224.5MM
Rate: SIFMA[2] (0.04%) + 4.25%
Interest Payment: Monthly
Amort: None

Taxable:
Principal: $50.5MM
Rate: 1m LIBOR[3] (0.15%) + 4.75%
Interest Payment: Monthly
Amort: None

Period Two: Upon Public Offering and Fixed Rate Conversion(estimated)

Tax-Exempt:
Principal: $224.5 MM
Rate: 5.5%

Taxable:
Principal: $50.5 MM
Rate: 6.0%

Initial ratings would be the same for taxable and tax exempt bonds, and could be in the "A" range. When Barclays commits its balance sheet that means they are willing to buy the bonds directly for their own account. This has no impact on the rating, but it adds great credibility to the City's statements to the court that it has access to the exit financing.

Explanation of interest rate modes and changes

ANSWER: The bonds will be sold initially to Barclays directly. While Barclays holds the bonds, they will bear interest at a variable rate. The tax exempt bonds would be set at the SIFMA Municipal Swap Index + 4.25% and the taxable bonds would be set at the one-month LIBOR rate + 4.75%. The bond documents would be drafted to allow the interest rates to shift

[2] "SIFMA" represents the Securities Industry and Financial Markets Association municipal swap index is a 7-day high-grade market index comprised of the tax-exempt Variable Rate Demand Obligations (VRDOs) with certain characteristics; http://www.sifma.org/research/item.aspx?id=1690.

[3] "LIBOR" represents the London Interbank Offered Rate, and is the most popular barometer for short-term interest rates around the world. Calculated by averaging interest rates charged by London banks for periods ranging from overnight to five years, the LIBOR is a benchmark used for financial instruments ranging from currencies to interest rate swaps and forward rate agreements; http://internationalinvest.about.com/od/gettingstarted/a/What-Is-The-Libor-Rate.htm?

among various interest rate modes upon the satisfaction of certain conditions. The modes usually include interest rates which adjust weekly, monthly and other intervals, and also allow conversion to a fixed rate. In this instance, within months after the effective date, the City expects the bonds to be converted to fixed rates in connection with a reoffering of the bonds by Barclays to the public, as described in the term sheet. Barclays would cease to be the bondholder at that time. The exact fixed rates would depend on the ratings assigned to the bonds at the time (this is the "Flex" feature). The documents will contain the terms for the conversion and the mechanism for setting the fixed rate are set forth in the documents so that the conversion is not considered a refunding under state law.

In each instance the City will pay the interest, whether variable or fixed, to the MFA, and the interest paid by the MFA to the bondholders will be based on the same mode.

LPD's comment:

These responses are acceptable. In a nutshell, the variable rates are estimated to be about 4.3% for the tax-exempt Exit Financing bonds and about 4.9% for the taxable Exit Financing bonds at time of emergence or issuance to January 31, 2015. Upon public offering and fixed rate conversion, the fixed rates are estimated to be about 5.5% for the tax-exempt Exit Financing bonds and about 6% for the taxable Exit Financing bonds.

Please let us know if we can provide any more information.